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# China's Transitional Economy: Interpreting its Significance

Andrew G. Walder

China's post-Mao economic reforms have generated rapid and sustained economic growth, unprecedented rises in real income and living standards, and have transformed what was once one of the world's most insular economies into a major trading nation. The contrast between China's transitional economy and those in Eastern Europe and the former Soviet Union could not be more striking. Where the latter struggle with severe recessions and pronounced declines in real income, China has looked more like a sprinting East Asian "tiger" than a plodding Soviet-style dinosaur mired in the swamps of transition. The realization that reform measures and energetic growth continue even after the political crisis of 1989 has made China a subject of intense interest far outside the customary confines of the China field. Understood increasingly as a genuine success story, it is moving to the centre of international policy debates about what is to be done to transform the stagnating economies of Eastern Europe, and various aspects of its case now figure prominently in academic analyses ranging from theories of the firm and property rights to the political foundations of economic growth.

For many, China's transitional economy is an intriguing anomaly: a transition heralded as difficult and painful has sparked an economic boom. As a gradual rather than abrupt transition to the market, with public industry protected rather than subject to privatization, China's reform path has confounded the widespread and deeply held belief that gradual reform and public ownership simply cannot work, not even as a transitional strategy.<sup>1</sup> Indeed, some have pointed to the apparent irony that China has succeeded precisely by ignoring the advice widely offered to East European nations by many prominent economic advisors.<sup>2</sup>

1. See Olivier Blanchard, Rudiger Dornbusch, Paul Krugman, Richard Layard and Lawrence Summers, *Reform in Eastern Europe* (Cambridge, MA: MIT Press, 1992); Olivier Blanchard, Maxim Boycko, Marek Dabrowski, Rudiger Dornbusch, Richard Layard and Andrei Shleifer, *Post-Communist Reform: Pain and Progress* (Cambridge, MA: MIT Press, 1993); János Kornai, *The Road to a Free Economy: Shifting from a Socialist System, The Example of Hungary* (New York: Norton, 1990); and Merton J. Peck and Thomas J. Richardson, *What is to be Done? Proposals for the Soviet Transition to the Market* (New Haven: Yale University Press, 1992). Peck and Richardson (p. 20) write, "the solution lies in abandoning the search for halfway houses, in abandoning the dream of a regulated market economy," while Kornai (p. 58) argues "it is futile to expect that the state unit will behave as if it were privately owned and will spontaneously act as if it were a market-oriented agent. It is time to let go of this vain hope once and for all...state ownership permanently recreates bureaucracy."

2. See Peter Nolan, "China's post-Mao political economy: a puzzle," *Contributions to Political Economy*, Vol. 12 (1993), pp. 71-87, and "The China puzzle: 'touching stones to cross the river,'" *Challenge*, Vol. 37 (January-February 1994), pp. 25-31; Thomas G. Rawski, "Chinese industrial reform: accomplishments, prospects, and implications," *American Economic Review* Vol. 84, No. 2 (May 1994), pp. 271-275, and "Progress without

This contrast with the former Soviet bloc would suggest that China's transitional economy has important policy and theoretical implications. But what are they? This depends on how one characterizes China's main reform measures and how successful one judges them to be; what factors one sees as responsible for this economic dynamism and how unique they are to China; and judgments about the sustainability of this growth, which are connected also with judgments about China's political institutions and their probable future. Opinions vary widely about all of these questions.

*What is notable about China's reform path?* Some see China's gradual and cautious approach towards liberalization and privatization as the antithesis of the "big bang" and "shock therapy" approaches advocated so often in Eastern Europe. Others emphasize to the contrary that China's reforms started with an early "big bang" of privatization and liberalization in agriculture, and that in industry the reforms have worked well only in the partially private "non-state" sectors of the economy.

*How successful are China's reforms?* Some see steady improvements in output, incomes, productivity and export capability throughout the economy, beginning in agriculture and spreading to collective and eventually even to the much-maligned state industry. Others see China as a half-reformed economy in which the relative success of the rural sector contrasts markedly with an urban industrial base chronically losing money and still stuck in the inefficiencies of the past.

*Does China yield lessons for other transitional economies?* Some see China as an alternative model of gradual reform, in which the steady introduction of competition and market mechanisms alters incentives and behaviour of actors throughout the economy, making unnecessary the hardships of shock therapy and rapid privatization and allowing a transitional economy to "grow out of the plan." Others see its rapid growth as due not to gradualism but to a daring abandonment of collective agriculture under uniquely favourable conditions: a largely agrarian economy with a socialist welfare system that covered only the urban population.

*Can China's successes be sustained, or do serious problems cloud the horizon?* Some see China's reforms as firmly rooted and sustainable, following an East Asian pattern of industrialization under authoritarian rule earlier taken in South Korea and Taiwan. In the most optimistic scenario, China will continue its recent pace of growth and emerge from authoritarianism early in the 21st century as the world's largest economy. Others, however, see a future fraught with risk and instability, of which the political and economic shocks of the late 1980s were but a foretaste. In this view, an uncertain leadership transition, growing potential for social instability, and continuing problems of inflation, unemployment, uprooted rural populations, deepening political corruption and declining

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privatization: the reform of China's state industries," in Vedat Milor (ed.), *Changing Political Economies: Privatization in Post-Communist and Reforming Communist States* (Boulder: Lynne Rienner, 1994), pp. 27-52.

central power all predict a hazardous road ahead.

The essays collected here seek to give clearer answers to these four questions and put China's transitional economy more firmly into international perspective.

### *What is Distinctive About China's Reform Path?*

Those who argue that China's reforms hold important lessons about transitional economies emphasize two features. First, the approach is gradual and flexible, involving evolutionary changes in institutions and policies. There is no rapid leap to free prices, currency convertibility or cutting of state subsidies. Secondly, privatization of government enterprise has not played a significant role, although a new but small private sector has emerged. Viewed from this perspective, China contradicts rather strikingly the advice of those who counsel a "big bang" – rapid or immediate release of price controls and subsidies and restrictions of foreign competition and investment – and the "mass privatization" through sale or direct distribution of state assets.<sup>3</sup>

This view has been challenged by proponents of rapid reform who argue that China bears out the wisdom of their advice. Their first counter-argument is that China's leaders, while timid about privatization and price reform, in fact implemented a bold and unprecedented "big bang" in agriculture early on, dismantling all forms of collective agriculture in favour of a system of family smallholding. This led rapidly to a doubling of agricultural output, and then to a release of labour and entrepreneurial energies into non-staple sidelines and non-agricultural pursuits. This rural "big bang," not China's gradualism, is what gave the economy a burst of growth at the outset.<sup>4</sup> Their second argument is that privatization *has* played a key role. The rural economy, they argue, is a form of private family farming; and in industry nearly half of industrial output was produced *outside* the state sector by the early 1990s. Therefore despite claims to the contrary, China's economy has already moved decisively toward privatization and it is precisely in the non-state sectors that economic dynamism has been most pronounced.<sup>5</sup>

3. See, for example, John McMillan and Barry Naughton, "How to reform a planned economy: lessons from China," *Oxford Review of Economic Policy*, Vol. 8, No. 1 (1993), pp 130–143; Barry Naughton, "What is distinctive about China's economic transition? State enterprise reform and overall system transformation," *Journal of Comparative Economics*, Vol. 18 (June 1994), pp. 470–490; Peter Nolan, "Transforming Stalinist systems: China's reforms in the light of Russian and East European experience," Discussion Papers on Economic Transition, Department of Applied Economics, University of Cambridge, August 1992; Rawski, "Progress without privatization," Ping Chen, "China's challenge to economic orthodoxy: Asian reforms as an evolutionary, self-organizing process." *China Economic Review*, Vol. 4, No. 2 (1994), pp. 137–142.

4. Jeffrey D. Sachs and Wing Thye Woo, "Structural factors in the economic reforms of China, Eastern Europe, and the former Soviet Union," *Economic Policy*, Vol. 18, No. 1 (1994), pp. 102–145.

5. *Ibid.* and Jeffrey Sachs, *Poland's Jump to the Market Economy* (Cambridge, MA: MIT Press, 1993), pp. 81–82, where in the midst of a spirited argument in favour of rapid privatization, we read, "But what about China? Hasn't China maintained state ownership and

These arguments are generally viewed sceptically by China specialists, even those who disagree with one another about other aspects of the reforms. While the commune system was rapidly dismantled in the early 1980s, peasants remained obliged to raise and sell quotas of staple crops at low state procurement prices for over a decade, almost all agricultural products and inputs remained predominantly under state pricing and distribution for many years, and to this day government commercial agencies dominate the marketing of output.<sup>6</sup> This gradual retreat from planned agriculture is exactly what the proponents of rapid and decisive change counsel against. It is not at all clear, moreover, that family farming *per se* is the key to rising grain output: while some analysts argue that productivity increases were directly attributable to the incentive effects of *de facto* family land ownership, others argue that the planned rise in state procurement prices and greater flexibility in cropping decisions are responsible for large portions of productivity increases.<sup>7</sup> The land ownership argument supports proponents of privatization, while the latter argument emphasizes incremental policy change.

The claim that most industrial output is now in a vaguely privatized "non-state" sector also meets with deep scepticism. Over 70 per cent of output in this sector is under a form of public ownership by local governments.<sup>8</sup> While township and village enterprises have been referred to occasionally as "semi-private," "*de facto* private" or as a "hybrid" property form,<sup>9</sup> most agree that they are nevertheless largely government

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yet succeeded in growing rapidly? The answer is yes, but the Chinese policymakers themselves know that state ownership has been a hindrance, not a help, to their economic growth since the start of the reforms. It is estimated that two thirds or more of state-owned enterprises are losing money in China. This has been a serious threat to macroeconomic stability. Moreover, the great dynamism of the country has come in the nonstate sector, including township and village enterprises and joint ventures."

6. See Terry Siular, "Grain pricing: a key link in Chinese economic policy," *Modern China*, Vol. 14 (October 1988), pp. 451–486, "Plan and market in China's agricultural commerce," *Journal of Political Economy*, Vol. 96 (1988), pp. 283–307, and "China's agricultural policy during the reform period," in Joint Economic Committee, Congress of the United States, *China's Economic Dilemmas in the 1990s*, Vol. 1 (Washington D.C.: U.S. Government Printing Office, 1991), pp. 304–364.

7. See Louis Putterman, "Dualism and reform In China," *Economic Development and Cultural Change*, Vol. 40 (April 1992), pp. 467–493, p. 475; John McMillan, John Whalley and Li Jing Zhu, "The impact of China's economic reforms on agricultural productivity growth," *Journal of Political Economy*, Vol. 97 (August 1989), pp. 781–807; Louis Putterman, "Does poor supervisability undermine teamwork? Evidence from an unexpected source," *American Economic Review*, Vol. 81 (September 1991), pp. 996–1001; and Scott Rozelle, "Decision-making in China's rural economy: the linkages between village leaders and farm households," *The China Quarterly*, No. 137 (March 1994), pp. 99–124.

8. See Barry Naughton, "Chinese institutional innovation and privatization from below," *American Economic Review*, Vol. 84, No. 2 (May 1994), pp. 266–270; Jean C. Oi, "Fiscal reform and the economic foundations of local state corporatism in China," *World Politics*, Vol. 45 (October 1992), pp. 99–126; Andrew G. Walder, "Local governments as industrial firms: an organizational analysis of China's transitional economy," *American Journal of Sociology*, Vol. 101, No. 2 (September 1995), pp. 263–301.

9. See Victor Nee, "Organizational dynamics of market transition: hybrid forms, property rights, and mixed economy in China," *Administrative Science Quarterly*, No. 37 (March 1992), pp. 1–27; Victor Nee and Su Sijin, "Local corporatism and informal privatization in China's market transition," Working Papers on Transitions from State Socialism No. 93-2,

owned and operated.<sup>10</sup> The common finding that private enterprises sometimes register as public, and that some rural officials appropriate public revenues as private income, qualifies but does not alter this observation.<sup>11</sup>

Beneath these disputes lies a deeper question about China's reform path. Those who see in China vindication of arguments for rapid marketization and privatization contend that successes have been limited to areas where these changes have been most pronounced. In this relatively critical view, China remains stuck in the contradictions of partial reform, and has only postponed the difficult tasks of final price and ownership reform. This view finds more support from China specialists, and raises the second question.

### *How Enviably is China's Record of Reform?*

Views of China's economic reforms come in many subtle shadings, but it is possible to identify two which are opposed: one emphasizing their limits and the difficult tasks postponed, and another emphasizing their cumulative breakthroughs. The first dominated the 1980s, especially outside the discipline of economics, and reached its greatest influence in the aftermath of the Tiananmen protests. The second gained adherents rapidly during the 1990s, especially among economists in academia and in international organizations.

The view that China exhibits the classic pathologies of partial reform has been persistent and popular. This reflects in part the influence of such critics of earlier partial reform in Eastern Europe as János Kornai, whose writings about Hungary suggested the incompatibility of market allocation with state ownership. Kornai's works became widely available in English-speaking countries just as China's reforms began, and they popularized the view that market reforms in a socialist economy create new problems (such as inflation and liquidity crises) without curing the underlying defects of central planning.<sup>12</sup>

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Einaudi Center for International Studies, Cornell; and Yusheng Peng, "Wage determination in rural and urban China: a comparison of public and private industrial sectors," *American Sociological Review*, No. 57 (April 1992), pp. 198-213.

10. See e.g. William A. Byrd, "Entrepreneurship, capital, and ownership," in William A. Byrd and Qingsong Lin (eds.), *China's Rural Industry: Structure, Development, and Reform* (New York: Oxford University Press, 1990), pp. 189-218; Jean C. Oi, "Commercializing China's rural cadres," *Problems of Communism*, No. 35 (September-October, 1986), pp. 1-15, and "The fate of the collective after the commune," in Deborah Davis and Ezra Vogel (eds.), *Chinese Society on the Eve of Tiananmen: The Impact of Reform* (Cambridge, MA: Harvard University Press, 1990), pp. 15-36; and Christine P. W. Wong, "Interpreting rural industrial growth in the post-Mao period," *Modern China*, No. 14 (January 1988), pp. 3-30.

11. See Nee and Su, "Local corporatism and informal privatization," Yialing Liu, "Reform from below: the private economy and local politics in the rural industrialization of Wenzhou," *The China Quarterly*, No. 130 (1992), pp. 293-316; Ole Odgaard, "Inadequate and inaccurate Chinese statistics: the case of private rural enterprises," *China Information*, Vol. 5 (Winter 1990), pp. 29-38.

12. See, for example, Christine P. W. Wong, "The economics of shortage and problems of reform in Chinese industry," *Journal of Comparative Economics*, No. 10 (December 1986),

Near the end of the 1980s, it was possible to see China's economy as bogged down in the contradictions of partial reform. Agriculture, which responded rapidly to reform measures in the early 1980s, met deepening difficulties. Grain prices could not rise to market clearing levels because of their impact on the urban cost of living, and grain output stagnated. Subsequent restoration of compulsory sales for staple crops led peasants to flee agriculture and shift to more lucrative sidelines and non-agricultural pursuits.<sup>13</sup> Compensating wage rises for urban workers would only make urban industry – the overwhelming source of the state budget – less profitable, while urban grain price subsidies could only lead to large state budget deficits – as they did in the early to mid-1980s. Meanwhile, urban state industry remained protected from competitive pressures and seemingly impervious to change. As Kornai predicted, enterprise managers bargained with bureaucratic superiors for more supplies of inputs at low state prices, permission to sell more output at high market prices, tax breaks and investment subsidies, in ways that might soften their budget constraint.<sup>14</sup> Moreover, as in Hungary years before, state managers consented to wage rises and better housing and benefits as a strategy to motivate their workers, feeding inflation.<sup>15</sup> The profitability of state firms deteriorated, requiring ever-larger subsidies.<sup>16</sup> Even the success story of township and village industry is seen by some observers as a wasteful

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pp. 363–387; Andrew G. Walder, "The informal dimension of enterprise financial reforms," in Joint Economic Committee, Congress of the United States, *China's Economy Looks Towards the Year 2000*, Vol. 1 (Washington, D.C.: U.S. Government Printing Office, 1986), pp. 134–149; Barry Naughton, "Hierarchy and the bargaining economy: government and enterprise in the reform process," in Kenneth G. Lieberthal and David M. Lampton (eds.), *Bureaucracy, Politics and Decision-Making in Post-Mao China* (Berkeley: University of California Press, 1992), pp. 245–279; and Andrew G. Walder, "Local bargaining relationships and urban industrial finance," in *ibid.* pp. 308–333. Kornai would later synthesize his arguments in *The Socialist System: The Political Economy of Communism* (Princeton: Princeton University Press, 1991).

13. Puttermann, "Dualism and reform in China," p. 478; James Kaising Kung, "Food and agriculture in post-reform China: the marketed surplus problem revisited," *Modern China*, Vol. 18 (April 1992), pp. 138–170, and Calla Weimer, "Price reform and structural change: distributional impediments to allocational gains," *Modern China*, Vol. 18 (April 1992), pp. 171–196.

14. Puttermann, "Dualism and reform in China," p. 478. See also Andrew G. Walder, "Wage reform and the web of factory interests," *The China Quarterly*, No. 109 (March 1987), pp. 22–41, and "Factory and manager in an era of reform," *The China Quarterly*, No. 118 (June 1989), pp. 242–264.

15. Puttermann, "Dualism and reform in China," p. 478. See also Walder, "Wage reform," and "Factory and manager"; Terry Sicular "Public finance and China's economic reforms," Discussion Paper No. 1618, Harvard Institute of Economic Research, November 1992, and "Going on the dole: why China's state enterprises choose to lose," unpublished paper, University of Western Ontario, May 1994. Sicular finds evidence of a managerial orientation to the maximization of retained funds rather than profits, and a propensity to spend these funds disproportionately on consumption and benefits for employees. However, she disputes the view that the profitability of state enterprises has suffered major declines.

16. Sachs and Woo write, "The results of attempts to reform the state sector have been extremely disappointing. On almost all fronts, the state-enterprise sector in China has continued to perform poorly. It is heavily loss-making; lagging in total factor productivity growth behind the non-state sector; dependent on state subsidies; and apparently suffused with economic corruption. China's growth has come despite the lack of discernible progress in establishing satisfactory performance of state industrial enterprises, with a heavy macroeconomic burden resulting from state enterprise losses" (p. 18).

duplication of investment activities that fails to take advantage of economies of scale, and whose uncontrolled growth generates inflation, material shortages, larger budgetary deficits and other symptoms of macroeconomic instability.<sup>17</sup> According to this view, China's growth masks serious structural problems.<sup>18</sup>

A second view acknowledges remaining problems, but emphasizes cumulative changes in the mechanisms by which the Chinese economy operates and evidence that the economy is responding to "partial" reform measures in ways thought improbable.<sup>19</sup> While state industry is changing more slowly than other areas of the economy, there are increasing signs that it too is responding to reform. Naughton finds that variation in profit rates across industrial sectors, an artifact of state pricing policy, has declined steadily, showing the increased exposure of state firms to market forces. As the state sector's monopoly position has been challenged by the entry of new firms operated by rural governments, overall profit rates in all industrial sectors decline and converge. The declining profitability of state industry reflects not the failure of reform, but its *success* in exposing this formerly protected sector to genuine competitive pressures.<sup>20</sup>

The centrepiece of this interpretation is that declining profits coexist with – and indeed may cause – increasing productivity in both state and rural collective sectors. Some researchers find that the declining trend of total factor productivity of the late Mao era has been reversed. While rural collective enterprises have improved their total factor productivity at more than double the rate of state industry, state industry itself began to respond to reform efforts in the mid-1980s, and its response then accelerated.<sup>21</sup> If these estimates are valid, they provide strong evidence of

17. Christine P. W. Wong, "Interpreting rural industrial growth," "Fiscal reform and local industrialization: the problematic sequencing of reform in post-Mao China," *Modern China*, No. 18 (April 1992), pp. 197–227, and "Central–local relations in an era of fiscal decline: the paradox of fiscal decentralization in post-Mao China," *The China Quarterly*, No. 128 (December 1991), pp. 691–715.

18. For a recent overview of China's reforms that emphasizes their limits, see Christine Wong, "China's economy: the limits of gradualist reform," in William A. Joseph (ed.), *China Briefing, 1994* (Boulder: Westview, 1994), pp. 33–54.

19. See especially Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978–1993* (New York: Cambridge University Press, 1995), and Rawski, "Progress without privatization."

20. Barry Naughton, "Implications of the state monopoly over industry and its relaxation," *Modern China*, No. 18 (January 1992), pp. 14–41. Sicular, "Public finance and China's economic reforms," however, argues that Naughton overstates the extent of the decline of profitability in state enterprises and also the declines in government revenue.

21. See the following series of publications, which lay out the evidence: Kuan Chen, Gary H. Jefferson, Thomas G. Rawski, H. C. Wang and Y. X. Zheng, "Productivity change in Chinese industry: 1953–85," *Journal of Comparative Economics*, No. 12 (1988), pp. 570–591, Gary H. Jefferson, Thomas G. Rawski and Yuxin Zheng, "Growth, efficiency, and convergence in China's state and collective industry," *Economic Development and Cultural Change*, No. 40 (1992), pp. 239–266, Gary H. Jefferson and Wenyi Xu, "The impact of reform on socialist enterprises in transition: structure, conduct, and performance in Chinese industry," *Journal of Comparative Economics*, No. 15 (1991), pp. 45–64. More accessible summaries of the evidence are provided in Rawski, "Progress without privatization"; Gary H. Jefferson and Thomas G. Rawski, "Enterprise reform in Chinese industry," *Journal of Economic Perspectives*, No. 8 (Spring 1994), pp. 47–70; and Thomas G. Rawski, "Chinese industrial

"progress without privatization" – that the reputed limits of partial reform have already been surmounted.

Others have developed estimates fully consistent with the "limits" interpretation: impressive productivity growth in rural industry, none in the state sector. They criticize alleged bias and error in the methodology used to develop more favourable estimates.<sup>22</sup> The first exchange about these estimates centred on methodological issues: how to deflate prices for intermediate inputs, and the characteristics of the enterprise samples.<sup>23</sup> The dispute so far appears inconclusive, especially given the small productivity increases under dispute.

This debate is important for judgments about the success of China's reforms: if there is convincing evidence that the state sector is turning round, then budget constraints are hardening for state firms despite all the theory to the contrary. The question would then become whether the rates of improvement in factor productivity seen in China are large enough, given the comparatively low productivity of state industry at the outset of reform, to make the reform strategy worth emulating. If gradual reform does work in state industry, this undercuts one of the central claims of those who advocate a "big bang" and mass privatization in other transitional economies. However, the question of China's relevance abroad hinges on much more than the debate about factor productivity in industry.

### *Is China Relevant to Other Transitional Economies?*

There is a logical equivalence between the tasks of reform in China and Eastern Europe. All these economies are struggling with legacies of a Soviet-style command economy, even though that model was not implemented identically in all regimes. All the command economies faced the same basic problems at the outset of reform: investment capital given as a grant, administered prices that did not reflect relative scarcities, domestic economies insulated from foreign competition and world prices, poor export performance, lack of competition on product markets, poor distribution networks, and so forth. All face the same initial dilemmas:

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reform: accomplishments, prospects, and implications," *American Economic Review*, Vol. 84, No. 2 (May 1994), pp. 271–275. The work of a second group who also find evidence of changes in the behaviour of state enterprises has recently begun to appear: Theodore Groves, Yongmiao Hong, John McMillan and Barry Naughton, "Autonomy and incentives in Chinese state enterprises," *Quarterly Journal of Economics*, Vol. 109, No. 1 (1994), pp. 183–209.

22. See Wing Thye Woo, Wen Hai, Yibiao Jin and Gang Fan, "How successful has Chinese enterprise reform been? Pitfalls in opposite biases and focus," *Journal of Comparative Economics*, Vol. 18, No. 3 (1993), pp. 410–437, and Wing Thye Woo, Gang Fan, Wen Hai and Yibiao Jin, "The efficiency and macroeconomic consequences of Chinese enterprise reform," *China Economic Review*, Vol. 14, No. 2 (1993), pp. 153–168.

23. See Gary H. Jefferson, Thomas G. Rawski and Yuxin Zheng, "Productivity change in Chinese industry: a comment," *China Economic Review*, Vol. 5, No. 2 (Fall 1994), pp. 235–241, and Wing Thye Woo, Gang Fan, Wen Hai and Yibiao Jin, "Reply to comment by Jefferson, Rawski and Zheng," *China Economic Review*, Vol. 5, No. 2 (Fall 1994), pp. 243–248.

the dangers of inflation arising from state subsidies and uncontrolled wage growth, the potential dangers of social unrest because of employment cutbacks in bloated state industry, how to make a credible commitment not to bail out loss-making firms. It makes sense to treat the transitional economies of Poland and China as variants of a single intellectual and policy problem.

However, the economies of Poland (or Russia) and China are at the same time very different, complicating the lessons to be drawn. One oft-mentioned difference is in sectoral composition: at the outset of reforms, employment in China was 75 per cent agricultural; in the USSR, 75 per cent in industry. The USSR was already an urbanized industrial society. One could therefore argue that China had yet to exhaust the "extensive" phase of its growth potential – the sources of growth in early industrialization accomplished via capital investment. The economies of Eastern Europe had long since done so, and were struggling with stagnation resulting from a failure to induce "intensive" growth – for which increased productivity due to organizational and technical innovation are the sources. China, in other words, could still achieve rapid growth rates by taking labour out of agriculture and increasing its productivity by putting it to work in industry.<sup>24</sup>

Such differences, moreover, may have made reform inherently more difficult for Russia and easier for China. Two decades ago the Soviet Union extended its social safety net – health insurance, job security, state pensions, and subsidies of living standards through places of work and residence – to the entire urban and rural labour force. In China, it covers only some 20 per cent, primarily in the urban state sector.<sup>25</sup> China's reformers have trodden lightly upon the security and benefits of its urban workers, but one can imagine how much more difficult reform would be if *all* Chinese citizens had these rights, and reform meant taking them away.<sup>26</sup>

Another potentially important difference is China's East Asian location and associated legacies. China is ringed by a number of vigorously expanding market economies that can serve as important markets and sources of investment. But more importantly, Hong Kong, Taiwan, Singapore and the Chinese diaspora in South-East Asia and North America are filled with ethnic Chinese entrepreneurs who have proved to be valuable sources of knowledge and investment and who have served as important bridges to the world economy. Hong Kong itself has played a major role in this respect for Guangdong province and much of the rapidly growing South China region.<sup>27</sup> And the swift development of rural

24. Sachs and Woo, "Structural factors." See also Wing Thye Woo, "The art of reforming centrally planned economies: comparing China, Poland, and Russia," *Journal of Comparative Economics*, Vol. 18 (June 1994), pp. 276–308.

25. Andrew G. Walder, *Communist Neo-Traditionalism: Work and Authority in Chinese Industry* (Berkeley: University of California Press, 1986), ch. 2.

26. Sachs and Woo, "Structural factors."

27. Ezra F. Vogel, *One Step Ahead in China: Guangdong Under Reform* (Cambridge, MA: Harvard University Press, 1989).

coastal regions appears to be building upon the foundations of a highly commercial past, on the traditional features of the Chinese family as an economic unit, and perhaps also upon the legacies of corporate property in single-surname villages. Russia and the other former Communist regimes enjoy no similar advantages.

China's Maoist legacies are also increasingly seen as a foundation for post-Mao success. Maoism introduced a much greater degree of regional decentralization of planning, investment and materials allocation than in the Soviet Union or any of the smaller countries of Eastern Europe,<sup>28</sup> a trend extended further in the rural industrialization programmes of the 1960s and 1970s.<sup>29</sup> China began its reforms with a more geographically dispersed industrial base, and with ownership and control distributed more evenly across the entire hierarchy of government.<sup>30</sup> This left local officials with the experience and the capacity to respond in an entrepreneurial way to subsequent reform policies.<sup>31</sup> Some see the decentralization of the Chinese economy as a structural factor that allowed China's reform strategy to work.<sup>32</sup> Such an historically path-dependent advantage is not transferable to other countries.

Finally, one fundamental difference between China and the former Soviet bloc is that Communist rule has collapsed elsewhere, while it survives in China. Economic reform has explicitly political objectives in all of these countries. Where in Eastern Europe shock therapy and mass privatization are designed in part to dismantle Communism and strip former Communists of power and privilege, in China gradual reform is intended to allow the Party to survive as an instrument of economic development. Proponents of rapid change have defended shock therapy and mass privatization as *political* programmes,<sup>33</sup> and authors of economic proposals for *post*-Communist regimes emphasize the fundamental difference between reforming a socialist economy and creating a *free*

28. See, for example, H. Franz Schurmann, *Ideology and Organization in Communist China* (Berkeley: University of California Press, 1968), Carl Riskin, *China's Political Economy* (New York: Oxford University Press, 1987), and Christine P. W. Wong, "Material allocation and decentralization: impact of the local sector on industrial reform," in Elizabeth J. Perry and Christine P. W. Wong (eds.), *The Political Economy of Reform in Post-Mao China* (Cambridge, MA: Harvard University Press, 1985).

29. See Carl Riskin, "Small industry and the Chinese model of development," *The China Quarterly*, No. 46 (April/June 1971), pp. 245–273, and Dwight Perkins (ed.), *Rural Small-Scale Industry in the People's Republic of China* (Berkeley: University of California Press, 1977).

30. See Christine P. W. Wong, "Ownership and control in Chinese industry: the Maoist legacy and prospects for the 1980s," in Joint Economic Committee, Congress of the United States, *China's Economy Looks Towards the Year 2000*, Vol. 1; and David Granick, *Chinese State Enterprises: A Regional Property Rights Analysis* (Chicago: University of Chicago Press, 1990).

31. See, for example, Byrd, "Entrepreneurship, capital, and ownership"; Oi, "Commercializing China's rural cadres," and 'Fiscal reform'; Christine P. W. Wong, "Between plan and market: the role of the local sector in post-Mao China," *Journal of Comparative Economics*, No. 11 (1987), pp. 385–398, and "Interpreting rural industrial growth."

32. Qian Yingyi and Chenggang Xu, "Why China's economic reforms differ: the M-form hierarchy and entry/expansion of the non-state sector," *Economics of Transition*, No. 1 (1993), pp. 135–170.

33. Sachs, *Poland's Jump to the Market Economy*, esp. pp. xiii and 43.

economy as the foundation for a *free* society – a liberal political vision reviled by China's leaders.<sup>34</sup> China's reform is inspired not by the impulses that drive what Sachs calls "Poland's return to Europe"; it is instead tailored to the vision of earlier East Asian developmental dictatorships that laid the foundations of a modern economy before eventual political liberalization and a shift to multi-party competition.

These considerations greatly complicate the drawing of lessons from China in two distinct ways. First, they raise questions about whether a similar approach to reform would be as successful outside China, given the special circumstances and legacies that its reform policies have enjoyed. Secondly, they raise deeper questions about whether it is China's specific strategy of reform, or some underlying legacy or historical advantage, that is behind its relative success.

### *Is China's Growth Sustainable?*

Judgments about the relevance of China's reforms often hinge on the question of whether the advances of the past 15 years will soon reach a point of diminishing returns. Some view partial reform as introducing inflation, fear of unemployment, liquidity crises and drops in state revenue that are bound to have serious economic and political consequences. Others view these transitional problems as manageable, and see the Chinese regime as better able to withstand popular pressures to curtail reform than the fragile new parliamentary democracies of Eastern Europe. Ultimately, views about the sustainability of China's reforms are based both on the analysis of the economy and on judgments about the interaction of economic and political change.

A relatively pessimistic strain has long been linked to the view that China's reforms are limited in scope and success. In this view, with the most difficult tasks of reform still lying ahead (such as the transformation of the urban state sector), China has already suffered serious bouts of macroeconomic instability and political unrest, and the prospect of serious reform of state industry creates the likelihood of rising urban unemployment. In addition, there is already a massive army of workers who migrate from the countryside in search of work, and who are thrown out of work during periodic economic downturns. And while inflation diminishes the real wages of officials, partial reform creates new opportunities for enrichment through corruption, because it permits officials to control vast productive resources.<sup>35</sup>

This troubling scenario found its fullest expression in May and June 1989. Easily the largest unrest faced by any Communist regime during that tumultuous year, Tiananmen appeared to be the climactic act in the pessimist's script for partial reform. Rapid inflation, popular disgust over

34. Kornai, *The Road to a Free Economy*, esp. pp. 17 and 22–23.

35. An excellent statement of this interpretation is Kathleen Hartford, "The political economy behind Beijing Spring, 1989," in Tony Saich (ed.), *The Chinese People's Movement: Perspectives on Spring 1989* (Armonk, N.Y.: M. E. Sharpe, 1990), pp. 50–82.

official corruption and fear of looming unemployment spilled over into dissatisfaction about the slow pace of political liberalization. Many writing in the aftermath of Tiananmen thought the episode marked a dead end for the strategy of limited reform.<sup>36</sup>

From this perspective, the Chinese path appeared to reach its end. Reform created new sources of instability and dynamism, and weakened the political order as a result of a corruption that threatened the organizational integrity of the state and caused the legitimacy of the regime to sink to one of its lowest points. Infighting among the political elite triggered by student protests underlined how fragile were the relations among top leaders, and how insecure were arrangements for political succession. Some concluded that only serious political reform could ensure an orderly transfer of power and recoup the kind of popular support necessary to carry out the more painful urban reforms. While Eastern Europe was laying a foundation for pluralistic political institutions suited to a market economy, China postponed the difficult problems to an uncertain future.

Others subscribe to an optimism fuelled by the resumption of market reform and rapid growth in the 1990s, and by the stagnating economies and unstable polities that have emerged in much of Eastern Europe. This view does not deny problems of inflation, financial instability, corruption and so forth, but interprets them as transitional diseases rather than terminal illnesses.<sup>37</sup> One important corollary of this optimism is the view that deep structural changes have already occurred in the economy. Central industrial planning is now a shadow of its former self, as market forces and competition have penetrated key sectors of the economy, and China has become deeply involved in international trade and finance.<sup>38</sup> These changes are seen as irreversible: any attempt to turn back would involve heavy economic and political costs, and spirited resistance from the population and from within the government itself.<sup>39</sup>

36. See e.g. *ibid.*, and Andrew G. Walder, "Workers, managers and the state: the reform era and the political crisis of 1989," *The China Quarterly*, No. 127 (September 1991), pp. 491–92.

37. Nicholas Lardy argues persuasively that reports of the death of China's reforms in 1989 were greatly exaggerated in "Is China different? The fate of its economic reforms," in Daniel Chirot (ed.), *The Crisis of Leninism and the Decline of the Left: The Revolutions of 1989* (Seattle: University of Washington Press, 1991), pp. 147–162. China's record of macroeconomic stability in fact has been quite positive when compared to other transitional economies. See Ronald I. MacKinnon, "Financial growth and macroeconomic stability in China, 1978–1992: implications for Russia and other transitional economies," *Journal of Comparative Economics*, Vol. 18 (June 1994), pp. 438–469.

38. See, for example, William A. Byrd, *The Market Mechanism and Economic Reforms in China* (Armonk, N.Y.: M. E. Sharpe, 1991), Naughton, *Growing Out of the Plan*, and Nicholas Lardy, *Foreign Trade and Economic Reform in China, 1978–1990* (Cambridge: Cambridge University Press, 1992), all of which document the gradual but fundamental changes in the principles by which China's economic system operates.

39. See Andrew G. Walder, "The quiet revolution from within: economic reform as a source of political decline," in Andrew G. Walder (ed.), *The Waning of the Communist State: Economic Origins of Political Decline in China and Hungary* (Berkeley: University of California Press, 1995), pp. 1–24.

Moreover, in retrospect China's strategy of pursuing economic reform without political change appears to have been a wise choice.<sup>40</sup> For China faces only one major transition: from a command to a market economy. Post-Communist regimes face a daunting "dual transition," attempting an historic transformation of the economy while at the same time trying to build stable and effective democracies out of the ruins of a single-party dictatorship. Some of these new democracies face problems of legitimacy as deep as China's regime at the end of the 1980s. The fragility of parliamentary coalitions in Eastern Europe makes the formulation and implementation of economic reforms difficult.<sup>41</sup> Elections as a constraint upon government make it much more difficult to carry out policies that create unemployment and reduce incomes in the short term.<sup>42</sup> Therefore it is possible to view China's continuing dictatorship as a form of government well-suited to the implementation of economic policies that an electorate would not choose for itself, or that an unstable democracy could not successfully undertake.

But how stable will China's "developmental dictatorship" be? Many observers have commented on the erosion of central state power.<sup>43</sup> The balance of control over total revenues in the wake of tax reform, for example, has shifted decisively in favour of the provinces and localities. In addition, the rise of revenue and income generating opportunities outside the planned economy has been seen to reorient local officials towards market opportunities rather than to their bureaucratic superiors for their personal advancement.<sup>44</sup> Some observers see in this erosion of central dominance a cause for alarm: a serious decline in China's central state capacity that threatens macroeconomic stability, the organizational integrity of the state and potentially even national unity.<sup>45</sup> Others see it as

40. See Susan L. Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993); Marshall I. Goldman and Merle Goldman, "Soviet and Chinese economic reform," *Foreign Affairs*, Vol. 66, No. 3 (1988), pp. 551-573; and Marshall I. Goldman, *Lost Opportunity: Why Economic Reforms in Russia Have Not Worked* (New York: Norton, 1994).

41. See, for example, Sachs' discussion of privatization in *Poland's Jump to the Market Economy*, and the discussion of stalled reforms in Russia in Olivier Blanchard *et al.*, *Post-Communist Reform: Pain and Progress* (Cambridge, MA: MIT Press, 1993), chs. 2-4, and Goldman, *Lost Opportunity*.

42. Mancur Olson argues that the greater openness of democracy to the influence of special interest groups has so far made the problems of soft budget constraints worse. See his "From communism to market democracy: why is economic performance even worse after communism is abandoned?" unpublished paper, University of Maryland, n.d.

43. See Wong, "Fiscal reform and local industrialization," and Shaoguang Wang, "The rise of the regions: fiscal reform and decline of central state capacity in China," in Andrew G. Walder (ed.), *The Waning of the Communist State: Economic Origins of Political Decline in China and Hungary* (Berkeley: University of California Press, 1995), pp. 87-113.

44. See Walder, "The quiet revolution from within," and "The decline of Communist power: elements of a theory of institutional change," *Theory and Society*, Vol. 23 (April 1994), pp. 297-323.

45. See Shaoguang Wang, "The rise of the regions," and Wang Shaoguang and Hu Angang, *Zhongguo guojia nengli baogao* (*A Report on China's State Capacity*) (Shenyang: Liaoning renmin chubanshe, 1993).

a positive sign: as a “market preserving federalism” in which economic competition among provincial and local governments serves to deter any single locality from arbitrary and unproductive intervention in the realm of marketing and taxation, because investors and customers could flee to more favourable jurisdictions.<sup>46</sup> These same observers argue that the eventual codification of this informal “federalism” into legally defined powers and rights of central and regional government could provide a path towards institutionalized political competition<sup>47</sup> – one not usually considered by those who herald the rise of “civil society” as *the* way in which democracy shall evolve.

Gauging the sustainability of China’s progress therefore draws attention to the interaction of economic and political institutions. On the one hand, economic reforms have had a discernible impact on politics either through their effects on ordinary citizens and the creation of social unrest or by directly affecting state structures themselves. On the other hand, economic progress depends on the stability and coherence of political institutions. The ultimate question is whether China’s can serve this purpose for a sufficient period of time, or whether they will become so weakened that growth will stall amidst corruption and political strife. The answer lies far beyond the boundaries of economic inquiry.

### *Conclusions*

The articles collected here all grapple with one or more of these questions. Some offer forceful answers, while others seek to correct widespread misconceptions or redefine the questions. The first two articles ask whether China enjoyed advantages that may have made its reform path easier. Peter Nolan and Robert Ash question the common assumption that China’s lower level of industrial development gave it obvious advantages over the Soviet Union. They argue that the *ex ante* wisdom is specious: if one had examined the economic prospects of the USSR and China at the outset of reform one would not necessarily have predicted that China’s advantages were so clear as they are now seen to be. Martin Whyte, focusing on the potential entrepreneurial role of the family, finds that the Chinese family emerged from Maoism strong, while the Russian family disintegrated under the impact of urbanization and economic change.

The next four articles examine various dimensions of China’s economy: agricultural commerce, property rights, foreign trade and macroeconomic stability. Terry Sicular argues that China’s agrarian reforms were far from a “big bang”; instead, they gradually released control over prices

46. See Gabriella Montinola, Yingyi Qian and Barry R. Weingast, “Federalism, Chinese style: the political basis for economic success in China,” *World Politics*, Vol. 48 (October 1995), pp. 50–81; and Ronald I. McKinnon, “Market-preserving fiscal federalism: notes on the American and Chinese models,” unpublished paper, Stanford University, August 1993. See also McKinnon’s “Spontaneous order on the road back from socialism: an Asian perspective,” *American Economic Review*, No. 80 (May 1992), pp. 31–36.

47. Montinola, Qian and Weingast, “Federalism, Chinese style.”

and marketing outlets, a process managed throughout by state commercial agencies, who remain deeply involved to this day. Louis Puttermans adjudicates the competing claims of those who argue that China has undertaken extensive *de facto* privatization and those who argue that China has maintained public ownership, and suggests that there has been extensive change in the allocation of property rights in China, though the dichotomous public/private distinction helps little to understand them. Nicholas Lardy finds that net foreign investment is almost a negligible factor in China's overall growth rate, although it has proved crucial in generating exports, as the traditional state sector has so far lagged a long way behind the foreign invested firms. Barry Naughton takes on conventional wisdom about macroeconomic instability in China and argues provocatively that investment, not subsidies, are the problem. Net subsidies to loss-making state firms are a tiny fraction of the state budget, and budgetary subsidies for living standards have fallen steadily. Naughton replaces the image of a weak central state struggling to cover state enterprise debts with one of a strong state pushing forward investment, but still without sophisticated instruments to modulate an economy now largely driven by market mechanisms.

Two subsequent articles examine the role of political institutions. Steven Goldstein reviews arguments of political scientists about the connection between political and economic reform in Soviet-style regimes, and argues that variations in the structures of Communist polities and economies have allowed China to defy the predictions of those who see party dictatorship as incompatible with market reform. Looking ahead, however, Goldstein wonders whether China's escape from this oft-emphasized connection will prove to be temporary. Jean Oi sees in China the emergence of a distinctive new variant of the East Asian developmental state. Unlike the other interventionist states of the region in which the central government is the only actor of interest, local governments play a crucial role – not solely through “industrial policy” but through direct ownership and entrepreneurship in the promotion of local industry.

Thomas Rawski's concluding synthesis of the lessons of China's reforms critiques the dogmatism of some economic analysis and calls for greater institutional and historical realism. At the same time, he emphasizes what an open mind may learn from studying China – both about the process of institutional change in *any* transitional economy and about the assumptions of mainstream economic theory.

These articles do not present a unified argument about China's transitional economy, but I detect three overriding conclusions about which there is consensus. The first is that history and institutions matter, and China has indeed enjoyed legacies that have assisted its path from a command economy. Nolan and Ash dispose of the idea that China's low level of industrialization was advantageous, but others identify legacies that do appear to have assisted the progress of reform. Whyte shows how the Chinese family emerged from the period of collectivism with a much higher capacity to sustain small-scale entrepreneurship than the Russian

family. Lardy notes that Maoist austerity allowed China to begin its engagement in the world economy without severe international debt and poor credit ratings. Puttermann and Rawski both point out that the dispersal of industrial ownership across local jurisdictions served to heighten the interest and experience of local cadres in industry, while Oi argues explicitly that the Mao era left a strong political infrastructure which, combined with new tax incentives, laid the foundation for rural China's rapid industrialization. All these essays favourably distinguish China's starting point from other transitional economies.

The second conclusion is that despite its historical and institutional distinctiveness, China nevertheless holds important lessons for all transitional economies. These lessons do not involve imitation of any specific Chinese policy, and "gradualism" is now a moot point, because the pace of change in Eastern Europe has in the end been no faster than in China. Perhaps the most important lesson is that economics (and nearby disciplines) has as much to learn from transitional economies as it has to teach them. Rawski makes very clear the weakness of much economic analysis when applied to transitional economies; Nolan and Ash find that China's refusal to heed the advice of Western economists, and Russia's effort to implement it, assisted China's rise and Russia's fall. Sicular argues explicitly that the distinction between "plan" and "market" no longer helps one understand China's agricultural commerce; Puttermann questions the categorical conception of property rights that underlies the macroeconomist's faith in privatization; Oi questions the commonplace assumption that public bureaucrats cannot behave as if they were private entrepreneurs. While all these authors share the view that there are no authoritative answers, and that persistent pragmatic experimentation through time can work, they also share a deeper assumption: successful reform involves the relentless introduction of choice, alternatives and competition into the environment of all actors in the economy, regardless of who they are.

This last point leads to the third and final conclusion, which I find to be the most important of all. A transitional economy must alter incentives not merely for individuals and firms but for government agencies and government officials themselves, for the behaviour of the latter can have enormous economic consequences. Conventional economic analysis, upon which much policy advice has been based, is remarkable for the degree to which it is blind to the analysis of government agencies and officials. Yet the articles collected here are all about the shifting opportunities and constraints facing them. Sicular emphasizes the strong market incentives to which state commercial organs now must respond. Naughton shows the market-driven processes with which the central state must increasingly grapple. Oi analyses the incentives that turn rural bureaucrats into market-oriented entrepreneurs. Rawski argues that competition for resources affects the behaviour of all actors, be they state finance officials, managers of large state factories or petty entrepreneurs. A transitional economy is defined as one undergoing profound institutional change, and institutional change involves changing incentives and

constraints facing all actors whose behaviour has economic consequences. This, then, is the final lesson of China's reforms: the task is not to revile state involvement but to change it.